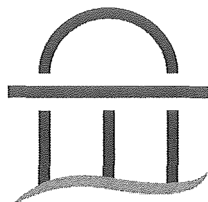

24 July 2009

Ms Jessica Lion
Australian Accounting Standards Board
Level 7, 600 Bourke Street,
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AUSTRALIA

By E-mail: jlion@aasb.gov.au

Dear Jessica

IASB Exposure Draft: Income Tax

Thank you for the opportunity to provide our comments on IASB Exposure Draft ED/2009/2 Income Tax.

The Property Council is the peak body representing the interest of investors in Australia's $360 billion commercial property investment industry.

Approximately 2000 companies are members of the Property Council, ranging from Australia's largest institutions to private investors and developers covering the four quadrants of real estate investing - public, private, debt and equity.

The Property Council supports enhanced comparability of financial information between real estate companies worldwide.

We summarise below the key areas of the ED which will impact the real estate sector and in particular the Real Estate Investment Trust (REIT) sector which is the predominant vehicle used for investing in real estate in the Australian market.

Definitions of tax basis and temporary difference

The proposed definition of tax basis only considers the tax consequences of selling an asset or settling a liability.

We are concerned that the proposal does not reflect the economic and expected tax consequence of some transactions.

We suggest that the tax basis of an asset or liability is defined as the amount used for tax purposes under the relevant tax law. The tax basis of an asset would be the amount that is deductible against taxable income regardless of whether the deduction is available on use or on sale. The tax basis of a

liability would be the amount at which the liability could be repaid, settled, or assumed without realization of taxable income (gain) or expense (loss).

Initial recognition expense

We do not agree with the proposal to disaggregate the asset or liability on its initial recognition where a temporary difference arises.

The proposal will introduce unnecessary complexity.

We suggest that the requirement to recognize assets and liabilities using a market participant approach is retained which is consistent with business combinations accounting and that any premium/discount is recorded immediately in the income statement. This outcome is easily understood by users and is consistent with the accounting for a bargain purchase in a business combination.

Investments in subsidiaries, branches, associates and join ventures

We support the inclusion of an exception for foreign subsidiaries and extension to all foreign subsidiaries where the tax basis cannot be calculated reliably.

We recommend that the exemption be extended to domestic subsidiaries because tax balances are generally calculated on a group basis and separate calculations for each entity would be arbitrary, unreliable and costly.

A number of tax jurisdictions have grouping and consolidation regimes which do not require entities within a group to prepare individual taxation returns.

Uncertain tax positions

We do not agree with the proposal as drafted because:

1) we do not believe there is a commercial problem that necessitates these provisions; and

2) the proposed methodology for determining the uncertain position appears inconsistent with the way other liabilities are determined on the balance sheet.

If the Board considers that guidance is necessary, we recommend using the threshold test to ensure that each tax position "is more likely than not to be sustained" - which is analogous to using a threshold recognition criteria.

Disclosure requirements

We believe the Board should clarify whether it is intended to apply these provisions to entities such as REITs which are tax flow through entities.

In a large number of jurisdictions real estate is held in entities that maintain a "flow through" status for tax purposes. Any tax arising through operating the real estate is taxed in the hands of the beneficial owner. In addition the tax status of different owners in such entities will vary greatly and the actual tax outcomes within the entity may vary significantly from the tax accounting requirements.

The proposal would result in considerable preparation and audit cost without providing meaningful financial information, and potentially misleading disclosures.

We have included in the Appendix our detailed observations on those questions that we consider relevant to our industry.

We would be pleased to communicate further with the Board or its staff on any questions regarding our submission.

Yours sincerely

Roberto Fitzgerald
Executive Director International & Capital Markets
Property Council of Australia

Appendix A: Invitation to Comment

Question 1 - Definitions of tax basis and temporary difference

The exposure draft proposes changes to the definition of tax basis so that the tax basis does not depend on management's intentions relating to the recovery or settlement of an asset or liability. It also proposes changes to the definition of a temporary difference to exclude differences that are not expected to affect taxable profit. (See paragraphs BC17–BC23 of the Basis for Conclusions.) Do you agree with the proposals? Why or why not?

The proposed definition of tax basis considers only the tax consequences of selling an asset or settling a liability at the balance sheet date. This is simpler to apply than the current requirement under IAS 12 to consider management's intention to determine the tax basis.

The proposal does not reflect the economics and the expected tax consequences of some transactions. For example, when deductions are different for using an asset or selling it, the proposed model requires the tax basis to be determined based on recovery through sale, but requires management's intentions to be considered when determining the tax rate to be used to measure the resulting temporary difference. This inconsistency adds complexity and will be confusing to users.

We suggest the tax basis of an asset or liability is defined as the amount used for tax purposes under the relevant tax law. The tax basis of an asset would be the amount that is deductible against taxable income regardless of whether the deduction is available on use or on sale. The tax basis of a liability would be the amount at which the liability could be repaid, settled, or assumed without realisation of taxable income (gain) or expense (loss).

We believe that defining tax basis in the manner suggested will deal with the majority of situations and will result in outcomes that are consistent and understandable. This approach will also converge the IFRS accounting with US GAAP on this critical aspect of the accounting for income tax model.

Question 2 – Definitions of tax credit and investment tax credit

The exposure draft would introduce definitions of tax credit and investment tax credit. (See paragraph BC24 of the Basis for Conclusions.) Do you agree with the proposed definitions? Why or why not?

We welcome the Board's decision to define tax credits and investment tax credits. However we believe that the Board could further improve the consistency and transparency of income tax accounting by including an accounting principle for investment tax credits.

Question 3 – Initial recognition exception

The exposure draft proposes eliminating the initial recognition exception in IAS 12. Instead, it introduces proposals for the initial measurement of assets and liabilities that have tax bases different from their initial carrying amounts. Such assets and liabilities are disaggregated into (a) an asset or liability excluding entity-specific tax effects and (b) any entity-specific tax advantage or disadvantage. The former is recognised in accordance with applicable standards and a deferred tax asset or liability is recognised for any temporary difference between the resulting carrying amount and the tax basis. Outside a business combination or a transaction that affects accounting or taxable profit, any difference between the consideration paid or received and the total amount of the acquired assets and liabilities (including deferred tax) would be classified as an allowance or premium and recognised in comprehensive income in proportion to changes in the related deferred tax asset or liability. In a business combination, any such difference would affect goodwill. (See paragraphs BC25–BC35 of the Basis for Conclusions.) Do you agree with the proposals? Why or why not?

The requirement to disaggregate the asset or liability on its initial recognition where a temporary difference arises, into the asset or liability excluding any entity-specific tax effects will be virtually impossible to comply with. As noted throughout this submission the variability in tax outcomes for real estate transactions means the tax basis available to "market participants" in a transaction is not a readily available fact and will therefore require significant estimate and judgment to determine while providing little value to financial statement users.

We support the Board's objective to remove exceptions and we agree that this exception should be eliminated. However, we do not agree with the proposed accounting model. We recognise that there will be limitations associated with any model for initial recognition given that deferred taxes are not discounted but we believe that the proposed model introduces unnecessary complexity.

We suggest that the requirement to recognise assets and liabilities using a market participant approach is retained, consistent with business combinations accounting, but that any premium or discount is recorded immediately in the income statement. This would eliminate the exception and the complexity introduced by the proposed model. We acknowledge that this model will introduce some income statement volatility, but we believe it better aligns the accounting with that applied in a business combination. The outcome is easily understood by users and is consistent with the accounting for a bargain purchase in a business combination.

Question 4 – Investments in subsidiaries, branches, associates and joint ventures

IAS 12 includes an exception to the temporary difference approach for some investments in subsidiaries, branches, associates and joint ventures based on whether an entity controls the timing of the reversal of the temporary difference and the probability of it reversing in the foreseeable future. The

exposure draft would replace these requirements with the requirements in SFAS 109 and APB Opinion 23 Accounting for Income Taxes—Special Areas pertaining to the difference between the tax basis and the financial reporting carrying amount for an investment in a foreign subsidiary or joint venture that is essentially permanent in duration. Deferred tax assets and liabilities for temporary differences related to such investments are not recognised. Temporary differences associated with branches would be treated in the same way as temporary differences associated with investments in subsidiaries. The exception in IAS 12 relating to investments in associates would be removed. The Board proposes this exception from the temporary difference approach because the Board understands that it would often not be possible to measure reliably the deferred tax asset or liability arising from such temporary differences. (See paragraphs BC39–BC44 of the Basis for Conclusions.) Do you agree with the proposals? Why or why not? Do you agree that it is often not possible to measure reliably the deferred tax asset or liability arising from temporary differences relating to an investment in a foreign subsidiary or joint venture that is essentially permanent in duration? Should the Board select a different way to define the type of investments for which this is the case? If so, how should it define them?

In relation to the ED as drafted, we support the inclusion of an exception for foreign subsidiaries. In large global groups there are significant problems in attempting to establish a reliable tax basis for all entities in the group. In our view the conditions to apply the exception are onerous and we therefore suggest the exception be extended to all foreign subsidiaries where the tax basis cannot be calculated reliably.

We also recommend that consideration be given to extending the exemption to domestic subsidiaries on a cost benefit basis. In a number of jurisdictions tax grouping/consolidation regimes mean that entities within a group do not prepare individual tax returns. Tax balances are generally calculated on a group basis and calculation of a tax basis for each subsidiary would generally be an arbitrary and costly exercise and may result in the recognition of a deferred tax balance that will never crystallize.

Question 5 – Valuation allowances

The exposure draft proposes a change to the approach to the recognition of deferred tax assets. IAS 12 requires a one-step recognition approach of recognising a deferred tax asset to the extent that its realisation is probable. The exposure draft proposes instead that deferred tax assets should be recognised in full and an offsetting valuation allowance recognised so that the net carrying amount equals the highest amount that is more likely than not to be realisable against taxable profit. (See paragraphs BC52–BC55 of the Basis for Conclusions.) Do you agree with the recognition of a deferred tax asset in full and an offsetting valuation allowance? Why or why not? Do you agree that the net amount to be recognised should be the highest amount that is more likely than not to be realisable against future taxable profit? Why or why not?

Deferred tax assets should be recognised in full with an offsetting valuation allowance, if required. The approach is consistent with recognising an asset for a receivable and reducing it by an amount to account for probable non-

payment. It achieves greater transparency in the financial statements by disclosing the full amount of deferred tax assets by type of temporary difference and, separately, the amount of valuation allowance.

We are concerned, however, with the proposal that the net amount recognised should be the "highest" amount that is more likely than not to be realisable. We believe the recognition of the amount should be that which is probable (more likely than not) to be realised.

Question 6 – Assessing the need for a valuation allowance

The exposure draft incorporates guidance from SFAS 109 on assessing the need for a valuation allowance. (See paragraph BC56 of the Basis for Conclusions.) Do you agree with the proposed guidance? Why or why not? The exposure draft adds a requirement on the cost of implementing a tax strategy to realise a deferred tax asset. (See paragraph BC56 of the Basis for Conclusions.) Do you agree with the proposed requirement? Why or why not?

We agree with the proposed additional guidance on assessing the need for a valuation allowance. More clarity on how to allocate tax credits used in valuation allowances is required.

Question 7 – Uncertain tax positions

IAS 12 is silent on how to account for uncertainty over whether the tax authority will accept the amounts reported to it. The exposure draft proposes that current and deferred tax assets and liabilities should be measured at the probability-weighted average of all possible outcomes, assuming that the tax authority examines the amounts reported to it by the entity and has full knowledge of all relevant information. (See paragraphs BC57–BC63 of the Basis for Conclusions.) Do you agree with the proposals? Why or why not?

We do not agree with these proposals. The existence of commercial problems necessitating solution through these provisions is not evident and we consider these provisions unnecessary.

There is a commercial conflict in disclosing (through the probability assessment) worse-case views of tax liabilities whilst at the same time negotiating with the tax authorities. We believe this could be to the net detriment of shareholders.

If the Board is of the view guidance is needed in this area we would suggest that an entity is first required to consider whether each tax position is more likely than not to be sustained. It would also reduce the administrative burden of compliance by reducing the volume of issues for which an expected value would be calculated. The uncertainty associated with those that are more likely than not to be sustained should then be measured at expected value.

Question 8 – Enacted or substantively enacted rate

IAS 12 requires an entity to measure deferred tax assets and liabilities using the tax rates enacted or substantively enacted by the reporting date. The exposure draft proposes to clarify that substantive enactment is achieved when future events required by the enactment process historically have not affected the outcome and are unlikely to do so. (See paragraphs BC64–BC66 of the Basis for Conclusions.) Do you agree with the proposals? Why or why not?

We support the use of substantively enacted rates to measure tax assets and liabilities.

Question 9 – Sale rate or use rate

When different rates apply to different ways in which an entity may recover the carrying amount of an asset, IAS 12 requires deferred tax assets and liabilities to be measured using the rate that is consistent with the expected manner of recovery. The exposure draft proposes that the rate should be consistent with the deductions that determine the tax basis, i.e. the deductions that are available on sale of the asset. If those deductions are available only on sale of the asset, then the entity should use the sale rate. If the same deductions are also available on using the asset, the entity should use the rate consistent with the expected manner of recovery of the asset. (See paragraphs BC67–BC73 of the Basis for Conclusions.) Do you agree with the proposals? Why or why not?

There is an inconsistency in the proposal between how tax basis and tax rate are determined.. See Question 1. The tax rate used to measure deferred taxes should be consistent with the tax basis.

Where a deduction is only available for using an asset, the tax basis will be that deduction, the tax rate would also be based on the tax consequences of using the asset. If the same deduction is available upon use or sale, entities should consider management's intention in determining the tax rate.

Question 10 – Distributed or undistributed rate

IAS 12 prohibits the recognition of tax effects of distributions before the distribution is recognised. The exposure draft proposes that the measurement of tax assets and liabilities should include the effect of expected future distributions, based on the entity's past practices and expectations of future distributions. (See paragraphs BC74–BC81 of the Basis for Conclusions.) Do you agree with the proposals? Why or why not?

We agree with this proposal. For REIT entities the ability to consider future distributions is important in determining an appropriate tax position.

Question 11 – Deductions that do not form part of a tax basis

An entity may expect to receive tax deductions in the future that do not form part of a tax basis. SFAS 109 gives examples of 'special deductions' available in the US and requires that 'the tax benefit of special deductions ordinarily is

recognized no earlier than the year in which those special deductions are deductible on the tax return'. SFAS 109 is silent on the treatment of other deductions that do not form part of a tax basis. IAS 12 is silent on the treatment of tax deductions that do not form part of a tax basis and the exposure draft proposes no change. (See paragraphs BC82–BC88 of the Basis for Conclusions.) Do you agree that the exposure draft should be silent on the treatment of tax deductions that do not form part of a tax basis? If not, what requirements do you propose, and why?

We agree with this proposal.

Question 12 – Tax based on two or more systems

In some jurisdictions, an entity may be required to pay tax based on one of two or more tax systems, for example, when an entity is required to pay the greater of the normal corporate income tax and a minimum amount. The exposure draft proposes that an entity should consider any interaction between tax systems when measuring deferred tax assets and liabilities. (See paragraph BC89 of the Basis for Conclusions.) Do you agree with the proposals? Why or why not?

We support this proposal but believe clearer articulation is required on this matter.

Question 13 – Allocation of tax to components of comprehensive income and equity

IAS 12 and SFAS 109 require the tax effects of items recognised outside continuing operations during the current year to be allocated outside continuing operations. IAS 12 and SFAS 109 differ, however, with respect to the allocation of tax related to an item that was recognised outside continuing operations in a prior year. Such items may arise from changes in the effect of uncertainty over the amounts reported to the tax authorities, changes in assessments of recovery of deferred tax assets or changes in tax rates, laws, or the taxable status of the entity. IAS 12 requires the allocation of such tax outside continuing operations, whereas SFAS 109 requires allocation to continuing operations, with specified exceptions. The IAS 12 approach is sometimes described as requiring backwards tracing and the SFAS 109 approach as prohibiting backwards tracing. The exposure draft proposes adopting the requirements in SFAS 109 on the allocation of tax to components of comprehensive income and equity. (See paragraphs BC90–BC96 of the Basis for Conclusions.) Do you agree with the proposed approach? Why or why not? The exposure draft deals with allocation of tax to components of comprehensive income and equity in paragraphs 29–34. The Board intends those paragraphs to be consistent with the requirements expressed in SFAS 109. Would those paragraphs produce results that are materially different from those produced under the SFAS 109 requirements? If so, would the results provide more or less useful information than that produced under SFAS 109? Why? The exposure draft also sets out an approach based on the IAS 12 requirements with some amendments. (See paragraph BC97 of the Basis for Conclusions.) Do you think such an approach would give more useful information than the approach proposed in paragraphs 29–34? Can it be applied consistently in the tax jurisdictions with which you are familiar? Why or why not? Would the proposed additions to the approach based on the IAS

12 requirements help achieve a more consistent application of that approach? Why or why not?

In relation to the issues addressed in Question 13, we agree that there is a need to revise the existing allocation model. We do not agree that income taxes should be allocated to components of comprehensive income and equity. Income taxes should be presented as a single line in the performance statement. This would reduce complexity, income taxes arise from transactions with taxing authorities and whilst they are affected by other transactions, they are separate from the underlying taxable activity to which they relate.

The results produced would not provide more useful information than that produced under SFAS 109. The proposal is complex and has an arbitrary nature of allocating income tax expense. Backwards tracing adds unnecessary complexity.

The requirements of IAS 12 are also complex, time consuming and often arbitrary.

The model proposed is likely to cause greater inconsistency due to the arbitrary nature of the allocations.

Question 14 – Allocation of current and deferred taxes within a group that files a consolidated tax return

IAS 12 is silent on the allocation of income tax to entities within a group that files a consolidated tax return. The exposure draft proposes that a systematic and rational methodology should be used to allocate the portion of the current and deferred income tax expense for the consolidated entity to the separate or individual financial statements of the group members. (See paragraph BC100 of the Basis for Conclusions.) Do you agree with the proposals? Why or why not?

We agree with the proposal and believe the principal should be expanded so that it applies to tax groups, for example where group relief applies.

Question 15 – Classification of deferred tax assets and liabilities

The exposure draft proposes the classification of deferred tax assets and liabilities as current or non-current, based on the financial statement classification of the related non-tax asset or liability. (See paragraphs BC101 and BC102 of the Basis for Conclusions.) Do you agree with the proposals? Why or why not?

Classifying the deferred tax amounts based on the financial statement classification of the related non-tax asset or liability has no connection with the timing of the actual tax cash-flows. The proposal is not helpful to assessing the liquidity position of an entity.

Question 16 – Classification of interest and penalties

IAS 12 is silent on the classification of interest and penalties. The exposure draft proposes that the classification of interest and penalties should be a

matter of accounting policy choice to be applied consistently and that the policy chosen should be disclosed. (See paragraph BC103 of the Basis for Conclusions.) Do you agree with the proposals? Why or why not?
We agree with the proposal that the classification of interest and penalties should be a matter of accounting policy choice.

Question 17 – Disclosures

The exposure draft proposes additional disclosures to make financial statements more informative. (See paragraphs BC104–BC109 of the Basis for Conclusions.) Do you agree with the proposals? Why or why not? The Board also considered possible additional disclosures relating to unremitted foreign earnings. It decided not to propose any additional disclosure requirements. (See paragraph BC110 of the Basis of Conclusions.) Do you have any specific suggestions for useful incremental disclosures on this matter? If so, please provide them.

The proposed disclosures require significant amounts of information to be included for users of financial statements but it is questionable whether all users will find all of this information useful. For entities that are not subject to income tax because their income is taxed directly to their owners, the proposal will add additional accounts preparation and audit costs without providing any additional meaningful financial information.

The Board should clarify whether this provision is intended to apply to entities such as REITs which are not taxed due to distribution thresholds and compliance with other legislative requirements.

Question 18 – Effective date and transition

Paragraphs 50–52 of the exposure draft set out the proposed transition for entities that use IFRSs, and paragraph C2 sets out the proposed transition for first-time adopters. (See paragraphs BC111–BC120 of the Basis for Conclusions.) Do you agree with these proposals? Why or why not?

We agree with the general transition requirements to apply the guidance to the assets and liabilities in the opening statement of financial position for the first period beginning after the new IFRS is issued, with the adjustment recorded in retained earnings.